1-1-2006

An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?

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I. Introduction

What do chief executive officers (CEOs) bargain for in their employment contracts? If you read the labor law literature, you might think that these executives did not have contracts. Prominent legal academics have claimed that CEOs are at-will employees, just like rank-and-file workers.[1] If instead you read the corporate law literature, you might think that CEOs get whatever they want in their contracts. Leading legal academics have argued that corporate boards are all too willing to give CEOs fat pay packages and generous severance agreements because the directors are in the CEOs' back pockets.[2]

For all of the ink that has been spilled about CEO contracting processes and outcomes, however, no one has studied the contracts themselves. At the most basic level, do executives have contracts? If so, what are their common legal terms? Are they different from the employment arrangements of other corporate employees? Do these contracts reflect strong CEOs dictating to trembling directors whatever terms they want? Or are these agreements negotiated documents exhibiting provisions that serve both parties' interests well?

To answer these questions, we examined the key legal characteristics of 375 employment contracts between some of the largest 1500 public corporations and their chief executive officers. We looked at the actual language of these contracts and asked whether and in what ways CEO contracts differ from standard employment contracts for other workers. Our data provide some empirical answers to several common assertions or speculations in the labor law literature about CEO contracts and shed light on corporate law questions about whether these contracts are negotiated solely to suit the

1. *See generally* Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947 (1984).

2. *See* John Core, Wayne Guay, & Randall Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1158 (2005) (critiquing this managerial power theory); *see generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

preferences of CEOs or have provisions that also safeguard the employers' interests.

We begin by giving an overview of the general characteristics of a CEO employment contract and the process by which one is negotiated. This discussion shows that while some terms of these agreements are boilerplate language, there are intense negotiations over other terms. This background helps put into context the empirical information gleaned from the contracts.

Turning then to the contracts and the labor law issues surrounding them, we ask whether CEOs' employment contracts leave them as nothing more than glorified at-will employees. We focus on five contracting issues: (1) the term "just cause" that defines when an executive can be terminated involuntarily with penalties; (2) the "good reason" termination clauses in the contract that permit an executive to leave voluntarily without financial penalties; (3) the non-competition clauses in the contract; (4) the use of arbitration clauses to resolve contractual disputes; and (5) the contractual restrictions, if any, on the CEO's selling stock options. We also discuss some of the lesser-known economic terms of these contracts, including their length and the level of perquisites given to CEOs.

We find much evidence that CEOs are not generally at-will employees. First, with respect to termination provisions, we find that CEOs overwhelmingly contract around the at-will default standard of termination. Of 375 contracts in our sample, only twenty-five expressly declare the contract to be at-will. Thirteen contracts are in essence at-will as they give the CEO the same rights if dismissed with or without cause. Most of the remaining contracts (340) give the CEO greater rights if dismissed without cause. Even the expressly declared at-will contracts tend not to be so. Of those twenty-five contracts, twenty-four give the CEO greater rights for termination without cause. Furthermore, 86.93% of the contracts are for a definite term of years. This is quite different from the protections available to other workers, who are generally at-will employees without contracts.

Examining the definition of "just cause" for terminating a CEO, we find that the most commonly listed reasons are willful misconduct, moral turpitude, failure to perform duties, breach of fiduciary duties, and gross misconduct. All of these terms protect the CEO by sharply circumscribing the conduct for which he or she can be terminated with financial penalties. Interestingly, provisions that might protect the company's interests in actions against the CEO are much less common. For example, only two contracts mention sexual harassment (0.53%), thirteen mention incompetence (3.47%), and eighteen mention substance abuse (4.80%).

If we look at the other side of the coin, what happens when the CEO quits, we find that CEOs give up some of their freedom to quit their jobs by entering into these contracts. If we look at the definition of "good reason" in these contracts, we find that CEOs can terminate their employment for good reason and generally get the same payments as if the company terminated them without cause, if they are assigned duties inconsistent with their position, are involuntarily relocated, or are not compensated. Termination without good reason typically means a loss of severance benefits similar to that experienced by a CEO terminated for cause.

In terms of clauses that protect the company, we find that about two-thirds of the CEO employment contracts contain explicit do-not-compete clauses. The most common length of these restrictions is two years (46.64%), while the second most common is one year (31.62%). Almost three-quarters of these clauses are triggered by any termination, whether with or without cause, or with or without good reason. The length of these clauses correlates weakly with the amount of severance pay awarded to a departing CEO. The presence of these clauses suggests that companies get some benefit from continuing to pay departing CEOs after their departure from the company. It also indicates that these employment contracts are similar in this respect to severance agreements offered to lower level employees.

We next examine arbitration clauses. While we leave for future work a more detailed examination of these provisions, we do find that 41.60% of these contracts include a clause requiring the parties to arbitrate rather than litigate their disputes. This seems to indicate that CEOs, like other workers, bind themselves to arbitrate contractual disputes.

We next briefly describe the debate in corporate law about CEOs' influence over their pay. To shed some light on the power of CEOs in their negotiations with their firms, we examined the 121 change-in-control agreements included in the database compiled for our study. Our hypothesis was that CEOs would be able to get highly favorable provisions in these agreements because only an unwanted takeover of the firm would trigger their provisions, and the acquiring company would at least initially be the one held responsible for making any payments that the departing target company CEO would receive. In other words, the change-in-control agreement's terms illustrate what a CEO employment agreement might look like if CEO power was unchecked by the board.

We compared the basic legal terms of these change-in-control agreements with those contained in the employment contracts and found that, consistent with our expectations, they gave CEOs more latitude to quit with good reason than their regular employment agreements did. Relatively fewer change-in-control agreements included do-not-compete provisions than did CEO employment contracts, and this difference was statistically significant.[3] If change-in-control agreements contain the provisions that CEOs would like to have in their employment contract, but are unable to get, then the differences between the two types of contracts are strong evidence that CEO employment arrangements are not as one-sided as some critics have claimed.

We also look at the use of contractual restrictions to stop CEOs from engaging in transactions designed to eliminate all risks associated with stock options. We believe that these employment contracts would be the natural place where corporations could make CEOs promise not to unwind their stock option positions by using derivative securities. Yet, none of the contracts in our sample contains restrictions on hedging of a CEO's stock options, and only a handful have limitations on their sale or pledge. While such restrictions may appear in other agreements between the executive and the company,[4] we find the absence of such provisions curious if corporations are serious about curbing some of the reported derivative transactions involving stock options.

Looking at the economic terms of these contracts, we focus on the length of the contract and the use of specific perquisites because these are not widely disclosed in publicly available databases. We find that the most frequent length of CEO contracts is three years and the second most common length is five years. We also find that CEO employment contracts are quite specific about the types and quantities of perquisites that will be given to them. Some of the more lavish contracts include provisions for personal use of company aircraft, country club memberships, company cars, executive loans, spousal travel at company expense, and a host of other things. Given the very large amounts of money that these executives already earn for their efforts, we are surprised that companies are willing to offer them such a wide range of perks of this nature. The contrast between these economic terms and those given to lower level employees is apparent.

Part II of this Article describes the negotiation process for CEO employment contracts. Part III describes our data. Part IV examines employment law issues, and Part V focuses on corporate law questions.

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3. *See infra* Part V.B (discussing change-in-control agreements).

4. Restrictions on the sale of options are sometimes found in separate contractual agreements between the executive and the company, such as the company's stock option plan. For example, CDI Corporation grants its CEO stock options in the employment agreement, but the terms that govern these options are in a separate stock option agreement with the executive.

II. Negotiating Executive Employment Contracts: A Stylized Overview[5]

When an existing corporate CEO retires, dies, or is fired, the company's board must find a replacement. While the overall responsibility for the search process will fall on the entire board, an ad hoc committee of the board of directors generally runs the day-to-day management of the search. When the board is considering only internal candidates or is extending the contract of the incumbent CEO, the search committee will normally keep the process in-house, and may engage a compensation consultant to advise it on the appropriate level of compensation.

If it is considering outside candidates, the search committee will usually retain an executive search firm (ESF), at least for the initial hire and contract negotiations. The directors and the ESF will generate a group of up to ten to fifteen potential candidates for the position, a virtual "dream team" in the industry.[6] Using their contacts and information generated by the ESF, the search committee narrows the list down to a smaller set of generally three to five finalists. The committee will then interview these candidates, often secretly so that their current employers will not be aware of their potential interest. The search committee may ask the ESF to generate additional information about these finalists before making its final selection.

Once the search committee decides on its first choice, it will in most cases offer that candidate the position. The principal economic terms of its offer will be set forth in a term sheet.[7] The term sheet, or its oral equivalent, will set forth the proposed salary, target bonus, equity participation in the company (stock options, restricted stock, and any long-term incentive plans), severance package, change-in-control protections, benefits (health plans, supplemental executive retirement plan, deferred compensation, etc.), and standard perquisites. It would also cover such items as relocation expense payments, the term of years for the contract, the renewal provisions for the contract, the duties associated with the position, and the physical location for the executive. The executive and the company's representatives then negotiate any changes to these items with the ESF sometimes asked to act as an intermediary, subject to

5. This section is based largely on discussions with legal practitioners actively involved in negotiating executive employment agreements, sometimes on behalf of companies, and sometimes on the side of the executive. We have concealed their identities to preclude any possible adverse use of this information.

6. RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS 28 (2002).

7. The terms of the initial offer may be determined by the company's human resources department or through the use of information generated by the ESF.

later approval by the board of directors. The ESF may act as the go-between in these negotiations to insure that they go smoothly and are quickly resolved.

After the final term sheet is completed, both parties to the agreement will generally have their counsel negotiate the language and legal terms of the employment contract.[8] The company may choose to use inside counsel, or, in some cases, the company's outside lawyers, to handle the legal part of the negotiations. The executive will always retain an independent lawyer to handle the drafting or revising of any agreement. The language of the contract that ultimately comes out of this process, as in any negotiation, will reflect the relative bargaining strength of the parties, although some parts of the contract will be more heavily negotiated than others.

The company normally produces the initial draft of the contract, which can give it a significant advantage in the ensuing negotiations. The reason for giving the company this position is that these contracts become public information, which gives the company a strong interest in ensuring that it does not establish unfavorable future precedents in its negotiations with other employees or future CEOs. As a result, it can generally insist on having the right to prepare the initial draft. A potential CEO will prepare the initial contract only in instances where he or she has extraordinary negotiating power.

As soon as the lawyers sit down to the bargaining table to negotiate the contract's language, they begin the process of filling in the details not covered by the term sheet or oral substantive agreement. While details of the economic terms can be very important in these negotiations,[9] our focus is on the legal terms of the contract. In particular, our concerns are with the definitions of "just cause" and of "good reason," the arbitration provisions, any non-compete clauses, and any contractual restrictions on the use of derivative transactions relating to stock options. Remembering that every negotiation is different and that many of these terms are the subject of give-and-take between the parties, we offer the few generalizations gleaned from our sources.

First, as a general matter, incumbent CEOs generally have stronger negotiating positions than incoming CEOs for many reasons, including, most obviously, that they have already experienced some degree of success in

8. In some cases, the term sheet is not used, and the parties go right to the contract negotiations as the first written expression of the proposed deal. However, the main economic terms have been agreed to orally prior to the drafting and the remainder of the process is very similar to that which occurs in situations where a term sheet is used.

9. For example, the principals may agree to a two year severance package without specifying what compensation payments and benefits are to be continued during that time period. From the executive's perspective, it is important that the contract cover not only salary payments, but also potential bonus payments (and their computation), stock option vesting, benefits, and other potential continuing financial support.

running the company and have an ongoing relationship with the incumbent board of directors. There are two types of incoming CEOs: inside officers that have been promoted, and executives brought in from outside of the company. Between these two types, outsiders normally have more leverage in their negotiations than candidates promoted from within the company. These differences in negotiating strength significantly affect both the economic terms and the key legal components of the final contract.

The final terms depend on both the relative bargaining power of the parties and the importance of the clause. For example, executive terminations can be for cause or without cause. For-cause terminations normally hurt the executive's finances and reputation. Thus, executives are very concerned that they not be unjustifiably, or subjectively, fired for cause. In negotiations over the definition of "cause," however, there is normally little difficulty. Rarely are CEOs fired for cause. The exceptions arise out of situations involving flagrant abuses, such as blatant sexual harassment cases. Even if the contract's initial draft defines cause in a subjective manner, it is relatively easy for an executive's counsel to limit it to definite and specific instances of clear wrongdoing.

Executives can also choose to leave their job for another employer or to retire. Voluntary quitting can either be for good reason or without good reason. Voluntary terminations without good reason usually carry financial penalties for the executive, so executives want to have as broad a definition of "good reason" as possible. Companies, of course, have exactly the opposite perspective and want to limit good reason to a narrow set of circumstances to avoid having their CEOs leave easily for alternative employment. This can lead to hard bargaining over, for example, what constitutes a diminution of duties or responsibilities that could trigger a good-reason departure.

Both parties to a CEO employment contract frequently view arbitration clauses as desirable. Companies universally want to arbitrate disputes to keep matters private, and thereby avoid adverse publicity over a messy termination and possible public litigation. Normally, employees would want to preserve their right to a jury trial (but for the greater expense) because they calculate that a jury of their peers would be more sympathetic to their situation than to the company firing them. However, CEOs may have good reason to believe that juries will not identify with their compensation demands because the amounts involved may seem excessive to most members of the public. This may lead executives to favor arbitration generally, although they will still carefully negotiate such things as the selection process for the arbitrators and their right to appeal from an adverse decision.

Both parties hotly negotiate non-compete clauses. Companies are extremely sensitive to the potential for CEOs to walk away from the firm with its secrets in their heads and then work for competitors. Executives, on the other hand, do not want to be forced into long periods of unemployment in the area where they have been most successful. The parties must reconcile these competing interests, and the end result often reflects the company's willingness to offer extended periods of severance payments and judicial decisions limiting the enforceability of strong non-compete agreements.

Finally, we asked our sources about contractual limitations on executives' use of derivative security transactions for their stock options. Here, the company's board should be concerned about CEOs trying to enter into agreements to hedge the risk of their stock options dropping in value. Companies award options to executives as pay-for-performance and design the options to become valuable only if the company's stock price at the time they become exercisable exceeds the exercise price at which they were granted (almost always the current market price at the time they were issued). If CEOs can enter into a hedging transaction when they are granted the options that insures that they will receive a positive risk-free return on the options irrespective of how the company's stock price fares, then this destroys the incentives that the options should produce. Our sources said, however, that companies almost never request restrictions on hedging options.

Before turning to our discussion of the data, we should emphasize some of its limitations. First, because we cannot directly observe the negotiations that take place between boards and CEOs, we lack any direct measure of their respective negotiating strength. All we can observe is the outcomes of negotiations.

Second, we do not know what should be contained in an ideal CEO employment contract. Parties negotiate contracts against the background of existing U.S. laws, norms, and corporate governance practices, among other things. To the extent that our system creates a certain level of background negotiating strength for CEOs, perhaps because of American firms' board structure, or U.S. corporate law's limitations on shareholders' power to nominate directors, these contracts may not be negotiated on a completely level playing field.[10]

What we are able to observe is how much these contracts deviate from the average contract in our database. This allows us to make statements about the

10. *See* Core et al., *supra* note 2, at 1145 (describing the arm's-length bargaining model). This does not mean that the contracts are not optimal given the underlying corporate governance system.

relative strength of different types of provisions across our sample. Coupled with some general information about what CEOs want and what firms want, discussed above, this gives us some basis to draw conclusions about particular clauses. Even here though, we must be cautious, as these negotiations cover all aspects of the employment relationship, and one party may concede something in one area of the contract in order to obtain concessions on other terms more important to that party.

With this description of the process by which these contracts are negotiated as background, we turn next to an explanation of our data.

III. Description of the Data

A. Source of Data

We obtained our initial data set from The Corporate Library, an information clearing house formed in 1999 by Nell Minow and Robert Monks.[11] They compiled their database by contacting every company in the S&P 500, the S&P Midcap 400, and the S&P Small Cap 600,[12] and asking them to provide a copy of their CEO's employment contract. These contracts are public information as they are filed with the SEC as an exhibit to these companies' proxy statements. However, it is difficult to obtain copies because they are not included in the proxy statement sent to shareholders. Even getting them from the SEC's public documents room is difficult because it requires that the researcher know the filing date of the proxy materials in order for the SEC's staff to locate them. They are, however, available through the SEC's EDGAR database.

After several rounds of requests, the Corporate Library received replies from a total of 865 of these companies. Of the responding companies, 548 (63.7%) provided documents they claimed to be their CEO's employment contract, while the remaining 317 companies (36.3%) replied that their CEOs

11. The Corporate Library was previously named LENS Library, LLC, and was part of LENS Investment Management. It subsequently separated from LENS and changed its name. LENS Investment Management is an activist investment fund that seeks, among other things, to reform the corporate governance practices of its portfolio companies. Jeff Benjamin, *Rebellion Pays for a Newly Focused Lens; Company Plans to Offer Itself as Activist For Hire*, INV. NEWS, Jun. 19, 2000, at 6. *See generally*, The Corporate Library, http://www. thecorporatelibrary.com/ (last visited Jan. 14, 2006); Lens Library, http://www.lens-library.com/ (last visited Jan. 14, 2006); Lens, Inc., http://www.lens-inc.com/ (last visited Jan. 14, 2006).

12. Because of the time period of their survey, and the resultant movements in and out of the top 1500 companies because of things like mergers and acquisitions, the total number of companies that could be included in their database is 1632.

did not have employment contracts. When we examined the documents, however, we found that about one-third of them were not employment contracts at all, but rather a mix of change-in-control agreements, employment contracts for other employees, stock option plans, or miscellaneous unrelated documents.

Our initial reaction was astonishment that over one-third of CEOs did not have written employment contracts. We decided that we needed to investigate this information further, and so we purchased a subscription to LIVEDGAR, an online database that provides access to all SEC filings. For our purposes, LIVEDGAR has the great advantage of containing not only the main documents filed with the SEC, such as every registered company's Form 10-K, but also the attachments to those documents, which should include any employment contracts that they have with their top executives. We searched this database for the employment contracts for each of the companies that told The Corporate Library that they did not have any such agreements.

In the course of this search, we uncovered an additional eighty CEO employment contracts from companies that had told the Corporate Library that their CEO had no such contract. Furthermore, we found that the vast majority of the other CEOs had at least some other contractual agreement relating directly to their employment with their company. The most common examples of these contracts include severance (or termination) agreements, change-in-control agreements, consulting agreements, and non-competition agreements. In addition, there were a host of compensation-related agreements for many executives, such as deferred compensation agreements, stock option plans, and long term incentive plans. With the exception of the change-in-control agreements, we did not include these other documents in our sample.

Many contractual protections for CEOs are not contained in employment contracts, but rather in different contractual agreements. These different contracts' coverage overlap with the more traditional notion of an employment contract and make it hard to draw strong implications from the absence of an "employment contract" for the remaining firms that claimed their CEO had no employment contract. We should also note that the SEC does not monitor whether companies file their CEO employment agreements with their Form 10-Ks. It is therefore possible that some of the firms that told The Corporate Library that they did not have such agreements also choose not to make them publicly available.

In any event, the fact that so many CEOs have contractual protections, in the form of employment contracts or in other ways, suggests that they are quite different from other employees. Anecdotal evidence suggests that many, perhaps even most, employees do not work with a formal, written contract. While many countries require employment contracts to be in writing with specific provisions outlining pay, job duties, and other similar terms, American law does not.

To pursue the issue of what constitutes a CEO contract, we analyzed the documents that corporations gave to The Corporate Library. As we noted above, not all of those act as employment agreements.[13] We decided to limit our analysis to two categories of documents: employment contracts and change-in-control agreements.[14] Our reasons for examining the employment agreements are obvious, but the decision to examine the change-in-control agreements requires a bit more explanation.

Change-in-control agreements function as severance contracts in a sale situation. Among other things, they are designed to protect executives' firm-specific investments from expropriation if the executive is terminated involuntarily by the acquirer in an unwanted takeover.[15] The CEO and the target company's board normally negotiate these agreements before any announced takeover bid for the firm. However, an acquirer will at least initially bear the cost of these agreements. This potentially reduces the board's incentives to bargain hard over the terms of these agreements.[16] We therefore anticipate that some of their provisions may be more generous to CEOs than those contained in employment contracts.

Of the 496 documents in our sample, 75.6% (375) were CEO employment contracts and 24.4% (121) were change-in-control agreements. We examine the employment contracts in Part IV, and then in Part V we compare the terms of the change-in-control agreements with those in the employment agreements.

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13. It is illustrative of the overlapping functions of these agreements that so many corporations produced documents other than employment agreements in response to the request from The Corporate Library.

14. We had initially compiled an additional sample of sixty-nine amendments to CEO employment agreements. However, our preliminary analysis showed that they often incorporated by reference terms from earlier employment contracts. This made it difficult to compare their provisions with those in the regular employment contracts. We therefore decided to postpone further analysis of these agreements.

15. *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 10, 75–77 (1986) (discussing the effect of a change in control agreement on the risks associated with deferred compensation).

16. We recognize that a sophisticated acquirer may reduce the amount it is willing to pay for the target to take into account these additional costs. To the extent that the target company board is aware of this fact, they may be knowingly giving departing managers shareholders' money.

B. Description of the Variables[17]

With the help of several research assistants, we read each of these contracts and gathered information from them on over twenty-five variables.[18] We also collected information on firm size, including measures of market capitalization and number of employees, and four digit Standard Industry Codes (SIC) for each company. Part V uses this information to make cross industry and firm size comparisons on the use of different contractual terms.

From the contracts, we obtained data on the starting date of the contract, the length of the contract, the initial base salary provided for in the contract, whether the contract contained any provisions concerning the payment of bonuses to the CEO, whether the contract referred to stock option plans, and whether the contract mentioned other long-term incentive plans in which the CEO would participate. We used this information to determine whether the contract covered each of the basic forms of executive compensation and for what period of time.[19] We also collected information on other perquisites expressly granted to the executive as part of the contract, including cars, personal use of corporate aircraft, country club memberships, financial planning services, supplemental insurance policies, and loans.

We then looked at several different legal provisions in these contracts. First, we ascertained whether each contract contained a non-competition provision. These provisions restrict an executive's ability to move to a rival firm.[20] Where such provisions existed, we then determined the duration of the non-competition provision and the types of terminations that would activate these restrictions.[21]

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17. The following discussion relates to both the employment contracts and the change-in-control agreements. However, the change-in-control agreements did not contain all of the types of information that are discussed in the text.

18. *See infra* Part VII, Basic Data Appendix (summarizing data).

19. We did not attempt to quantify the size of the CEO's compensation package because that is not the focus of our current research, although we note that several commercial databases do contain this information and we could easily add it into our data set. For example, ExecuComp provides information on the value of each of these components for individual companies for the time period of the contracts included in our sample.

20. Some evidence exists that these provisions are becoming more common in executive employment contracts. *See* Rachel E. Silverman, *The Jungle*, WALL ST. J., Mar. 7, 2000, at B16 (reporting that in 1998 only 38% of executive employment contracts contained these provisions, whereas by 2000 roughly 70% of these contracts included these restrictions).

21. We included separate codes to cover five alternative situations: for any termination, any termination by the company, terminations by the company for cause only, any termination by the executive, or terminations by the executive without good reason only.

Next, we saw whether the contract required the parties to arbitrate their disputes. Third, we collected information on any contractual restrictions on sales, hedging, or pledging of stock options. Fourth, we looked to see if the contracts included change-in-control provisions that would grant the executive greater rights if a change in control of the company occurred.

Finally, we determined if each contract contained provisions for terminating the executive for "just cause," or for permitting the executive to terminate the contract for "good reason." In situations where the contract contained "just cause" provisions, we looked at how the contract defined "just cause."[22] We then performed a similar analysis for an executive's right to terminate the contract for good reason and asked first if the contract contained such provisions and then how it defined "good reason."[23] We also determined if the contract required the executive to give notice when terminating the contract, and if so, how long.

C. The Sample

The firms in our sample are S&P 1500 corporations. They come from the gamut of industries. The most prevalent are manufacturing firms (37.07% of our sample), including such well-known firms as Phillip Morris, General Electric, and Hewlett-Packard, and firms in transportation, communications, electricity, and gas (13.07%), such as Consolidated Edison, Sprint, and American Airlines. The largest employer in our sample, IBM, employs 316,303 workers, while Remington Oil and Gas employs only twenty (with market capitalizations of $158.65 billion and $67 million, respectively). Their mean market capitalization is $5.57 billion, with a minimum of $21 million and a maximum of $164.77 billion.

Our average CEO earns a base salary of $643,212. The CEO of Mirage Resorts in the services industry earns the most, at $2.5 million. This is more than twenty-five times the salary of the lowest-paid CEO in our sample. Mean total compensation is $1.65 million. The CEO of El Paso Corporation leads the way at $11.24 million. As expected, larger firms pay their CEOs more. We find that a ten percent increase in the number of a firm's employees correlates with a 1.8% rise in CEO salary.[24]

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22. We included separate codes for six different alternative definitions. These were willful misconduct, gross misconduct, incompetence, moral turpitude, conduct not in a good faith belief that it served the company (breach of fiduciary duty), and failure to perform stated duties with notice and board approval.

23. We included three variations of this definition: failure to compensate, assignment of duties inconsistent with the executive's position, and relocation.

24. This result corresponds to the elasticity of salary to number of employees estimated

In addition to salary, the vast bulk of the contracts also describe bonuses (90.13%), and over half mention long-term incentive plans (68.80%). Only seventeen CEOs in our sample have neither a bonus nor a long-term incentive plan mentioned in their contract, while 238 mention both.

Our contracts and change-in-control agreements span a number of years. Table 1 shows that the start dates of the contracts begin in 1984 and continue to 2003. The vast bulk of them, however, are from the late 1990s.

Table 1: Start Year of Agreement By Type of Agreement

Start Year of Agreement	Contracts	Change in Control Agreements
Missing	3	10
1984	2	0
1987	1	0
1988	1	1
1989	1	1
1990	6	1
1992	4	0
1993	5	1
1994	8	5
1995	14	8
1996	36	13
1997	60	11
1998	62	19
1999	88	22
2000	50	18
2001	29	10
2002	4	1
2003	1	0
Total	375	121

with a regression of the natural logarithm of salary on the natural logarithm of number of employees. The elasticity parameter is found to be statistically significant at a better than 1% level.

IV. Employment Law Characteristics of CEO Contracts

The CEO is an employee of the corporation, albeit at the top of the hierarchy. As with all private-sector nonunion employees in the United States, the default presumption is that the CEO is employed at-will. In his well-known defense of employment at-will, Richard Epstein has emphasized that the default at-will contract applies from the CEO to the janitor of the corporation.[25] This range of application of the at-will contract, Epstein argues, shows its flexibility and utility. If CEOs, with all their bargaining power, accept the at-will relationship, it cannot be true that at-will is a harsh construct thrust on oppressed workers because of their lack of bargaining power.[26]

A. Termination Clauses in CEO Contracts

In an effort to determine whether CEOs are at-will employees, we paid particular attention to the standard of termination in the CEO contracts. Overall, we find that, overwhelmingly, the CEO contracts around the at-will default in one way or another. This evidence casts doubt on the factual premise of the Epstein argument that CEOs, like other employees,[27] are governed by the at-will standard.

To complete the point that CEOs differ from the at-will status of other employees, we need to establish that these contracts are more than simply a fancy version of at-will contracts. It is surprisingly tricky to determine whether a CEO is employed at-will or can only be terminated for cause. In these contracts, at-will and "just cause" are not completely polar concepts. Three issues are intertwined. First is whether the contract lasts for a specific length of time (the so-called "definite term" contract) or for an indefinite time. The at-will presumption

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25. *See* Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 977 (1984) (noting that proposed reforms to at-will contracts would cover "the whole range from senior executives to manual labor").

26. For arguments of the harshness of the at-will employment relationship, emphasizing the lack of employee bargaining power as an explanation for why workers accept it, see generally Lawrence E. Blades, *Employment at Will v. Individual Freedom: On Limiting the Abusive Exercise of Employer Power*, 67 COLUM. L. REV. 1404, 1405 (1967); Cornelius Peck, *Unjust Discharges from Employment: A Necessary Change in the Law*, 40 OHIO ST. L.J. 1, 6 (1979); Clyde W. Summers, *Individual Protection Against Unjust Dismissal: Time for a Statute*, 62 VA. L. REV. 481, 483 (1976).

27. In an empirical survey of employment contracts of rank-and-file workers, Rip Verkerke has found that 52% contract explicitly for an at-will relationship (affirming the default presumption), while 15% explicitly contract for a just-cause dismissal standard. *See* J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate*, 1995 WIS. L. REV. 838, 867. Our findings for CEO contracts are strikingly different.

applies only to indefinite term contracts.[28] Second is whether the contract uses the words "at-will" or "just cause" or their equivalents, and how the contract defines these terms. Third is the remedy issue: Is a CEO fired without cause entitled to greater damages than if he or she were fired with cause?

In our sample, the bulk of contracts are for a definite term. Table 2 shows the range of contract lengths for our employment contracts. We find that the most common length is three years, with 128 out of 375 (34.13%) contracts falling in this category. Five years is the next most common length with eighty-six out of the 375 contracts in our sample running for this period of time (suggesting that the Stalinist idea of a five-year plan has some currency among S&P 1500 companies). Only eleven contracts do not include a term of any type in them, while another thirty-three say that they last until the CEO is terminated. Under standard employment law, a definite-term contract is not an at-will contract because dismissing the employee during the term would breach the contract (unless the company could show the employee breached his or her duty of loyalty). Thus, the vast majority of CEO contracts in our sample are not at-will but rather are definite term, contrary to the speculation of many.

Table 2: Length of CEO Contracts

Contract Length (Years)	# of Contracts	% of All Contracts
Length not mentioned	11	2.93%
Until CEO is terminated	33	8.80%
Until CEO is 60-65	5	1.33%
Length = 1	19	5.07%
1 < Length ≤ 2	36	9.60%
2 < Length < 3	7	1.87%
Length = 3	128	34.13%
3 < Length ≤ 4	24	6.40%
4 < Length < 5	4	1.07%
Length = 5	86	22.93%
Length > 5	22	5.87%
Total:	375	100.00%

28. For support for the proposition that at-will contracts arise from indefinite hirings, see the classic statement of the at-will rule by Horace G. Wood, MASTER AND SERVANT 272 (1877) ("With us [in America, unlike in England] the rule is inflexible, that a general or indefinite hiring is *prima facie* a hiring at will."). Horace Wood is often accused of inventing the at-will rules. *See, e.g.*, Theodore J. St. Antoine, *You're Fired!*, 10 HUM. RTS. 32, 33 (1982) (suggesting that the at-will rule sprang "full-blown in 1877 from [Wood's] busy and perhaps careless pen").

In addition to determining whether the contracts were definite-term or indefinite-term, we also looked at whether the employment contracts directly addressed the at-will issue. Only twenty-five of these contracts expressly declare that the relationship was at-will, a shockingly low number.[29] Another thirteen employment contracts, although not using the words "at-will," give no greater rights to a CEO dismissed without cause than to one for cause. The overwhelming bulk of CEO contracts (340) are just-cause contracts in the sense that the CEO gets greater rights if he or she is dismissed without cause.[30]

Why do contracts protect the CEO from arbitrary firings? The reason is presumably because the value to the CEO of just-cause protection exceeds the cost to the firm. Part of the harm to the CEO in being fired is reputational. Other firms will be reluctant to hire a CEO who has been fired because if the CEO did not work out in the old firm, he or she may not work out in the new firm either. If fired without cause, the CEO gets extra compensation. If the extra compensation is appropriately calibrated, this encourages the CEO to act sufficiently diligently to avoid being fired for cause and thus increases the CEO's effort.

The contractual definition of "just cause" is important in aligning incentives. As Table 3 shows, for the employment contracts in our sample, willful misconduct (259 out of 375), moral turpitude (271 out of 375), and failure to perform duties (217 out of 375) were the most common contractual bases for firing a CEO for cause. Less common, but still important defined terms, included breach of fiduciary duties (190 out of 375) and gross misconduct (147 out of 375).

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29. In twenty-four of these twenty-five contracts that claim to be at-will, termination with cause has adverse financial consequences (zero severance payment versus substantial severance payments if the executive is terminated without cause). In addition, twelve of these twenty-five contracts are definite-term contracts.

30. Twenty-two contracts do not define severance payments due to termination either with or without cause, so they cannot be compared.

Table 3: Actions Defined as Just Cause for CEO Termination

Action	# of Contracts	% of All Contracts
Not mentioned	9	2.40%
Mentioned but not specified	17	4.53%
Fiduciary breach	190	50.67%
Willful misconduct	259	69.07%
Gross misconduct	147	39.20%
Incompetence	13	3.47%
Moral turpitude	271	72.27%
Failure to perform duties	217	57.87%
Substance abuse	18	4.80%
Sexual harassment	2	0.53%

These figures are of tangential relevance to the Clinton impeachment hearings, where it was often asserted that a CEO in the private sector would be terminated for sexual dalliances. Assuming that such conduct constitutes moral turpitude, we find that 72.27%[31] of all our contracts would allow such a firing. However, our sample contains just two contracts that expressly say the CEO can be fired for sexual harassment. In a related vein, only eighteen of our contracts include substance abuse as a ground for just-cause termination.

Poor performance on the job does not constitute cause in most CEO contracts. We find that only thirteen of our contracts define incompetence as a reason for a just-cause termination. While extreme forms of incompetence could fall within other defined categories of cause, such as failure to perform duties, it seems odd that incompetence is not specifically listed as grounds for just-cause termination in many contracts. Furthermore, as corporate law scholars, we find it interesting that executives who breach their fiduciary duties to the firm are only subject to termination for cause in roughly half of these contracts.[32] Our expectation had been that every company would view such breaches as just cause for termination.

31. The 271 contracts allowing a moral-turpitude firing plus the only one at-will contract that does not specify just-cause actions (which would also allow a moral-turpitude firing) are 72.53% of our total sample of 375 contracts.

32. Even those agreements that define a breach of fiduciary duties as grounds for a just cause termination are frequently subject to important caveats. For example, ADC Telecommunication's 2003 employment contract with its CEO Robert Switz states that a breach of fiduciary duties constitutes grounds for just cause termination only if Switz does not have a "reasonable good faith belief" that he was acting in the company's best interests.

Table 4 shows the dramatic impact on a CEO's compensation if he or she is fired with cause. Overwhelmingly, termination with cause means that a CEO leaves the company without any severance payments.

Table 4: Salary Payments When CEO is Fired With Cause[33]

Payment in Terms of Base Salary	# of Contracts	% of All Contracts
CEO pays company	1	0.27%
Not mentioned in contract	14	3.73%
Mentioned but not specified	2	0.53%
Minimum of (balance of term, 3 years)	1	0.27%
Payment = 0	346	92.27%
Payment = 1 month salary	3	0.80%
Payment = 3 months salary	1	0.27%
Payment = 1 year salary	3	0.80%
Payment = 2 years salary	2	0.53%
Payment = 3 years salary	2	0.53%
Total:	375	100.00%

Turning to the question of how much notice the firm must give its CEO of his or her termination, we find that out of the 375 contracts, 299 require the firm to give a specific notice period before terminating a CEO's employment either with or without just cause. If the firm fires its CEO with just cause, the mean notice period is 11.95 days, with a median of 0 days, although the contracts range from zero to sixty days. The notice period is generally longer when the firm fires the CEO without just cause. In this situation, the average notice period is 28.77 days, with a median of thirty days, varying from zero to 360 days.

A related issue on CEO termination is what compensation the contract gives if a CEO is fired without cause. As Table 5 shows, most employment contracts call for some multiple of current salary to be paid to a CEO who is fired without cause. This is in stark contrast to what happens in a for-cause termination.

33. We have not included any bonus payments that would be paid out as part of a severance package.

Table 5: Payments When CEO is Fired Without Cause[34]

Payment in Terms of Base Salary	# of Contracts	% of All Contracts
Not mentioned	18	4.80%
Mentioned but not specified	3	0.80%
Lump sum for balance of term	23	6.13%
Salary continues for balance of term	51	13.60%
Payment = 0	7	1.87%
0 < Payment < 1 year salary	8	2.13%
Payment = 1 year salary	30	8.00%
1 year < Payment < 2 years salary	9	2.40%
Payment = 2 years salary	109	29.07%
2 years < Payment < 3 years salary	11	2.93%
Payment = 3 years salary	77	20.53%
Payment > 3 years salary	10	2.67%
Total:	356	94.93%

Note: Of our total sample of 375 regular contracts, we are excluding 19 with positive severance payments which are difficult to classify.

Two years' salary is the most common contractual award (109) for terminations without cause. There are also a significant number of contracts that provide for one year's salary (30) and three years' salary (77). A large number of employment contracts state that the CEO will have his or her salary continue for the balance of the term of the contract if terminated (51), while another substantial group provides that the CEO gets a lump sum payment equal to the amount of salary that he or she would receive over the remainder of the contract (23).[35]

34. We have not included any bonus payments that would be paid out as part of a severance package.

35. There are a number of other variations on how contracts calculate the CEO's salary severance package in a termination without cause. For example, one contract awards the departing CEO four times the amount of salary due for the remainder of the contract. Some contracts pay the CEO a lump sum equal to the maximum of one or two times the salary or the amount of the salary owed for the remainder of the contract. As there are relatively few of these contracts in the sample, we do not report them in the table.

Finally, in Table 6, we compare the severance salary payments that CEOs receive when they are fired with cause versus those that they receive when fired without cause. The latter payments are almost always greater.

Table 6: Comparison Between Salary Payments When CEO Is Fired With and Without Cause

Salary Payments When CEO Is Fired With Cause	Not Possible To Compare	Without Cause Are Greater	With and Without Cause Are the Same	Total
CEO pays company	0	1	0	1
Not mentioned in contract	14	0	0	14
Mentioned but not specified	2	0	0	2
Minimum of (balance of contract term, 3 years)	0	0	1	1
Payment = 0	6	333	7	346
Payment = 1 month salary	0	3	0	3
Payment = 3 months salary	0	1	0	1
Payment = 1 year salary	0	2	1	3
Payment = 2 years salary	0	0	2	2
Payment = 3 years salary	0	0	2	2
Total:	22	340	13	375

The flip side of the CEO being fired is the CEO quitting. As Table 7 shows, 293 contracts explicitly allow the CEO to quit for a good reason, suggesting that the CEO breaches the contract by quitting for a bad reason. As with other provisions in the CEO contract, CEO contracts on this quitting point operate differently than contracts for rank-and-file workers. The standard or default rule is that workers in an indefinite-term contract can quit at any time for any reason. Most CEOs appear to give up some of this freedom to quit at will and will breach the contract if they quit without a good reason.

Table 7: Can the CEO Terminate the Contract for Good Reason?

Good Reason	# of Contracts	% of All Contracts
Not mentioned	82	21.87%
Mentioned but not specified	18	4.80%
Mentioned and specified	275	73.33%
Total:	375	100.00%

In defining "good reason" for when a CEO can quit, most contracts allow the CEO to quit if any one of three criteria is met: the CEO's assigned duties are inconsistent with the position (253); the company fails to compensate the CEO according to their agreement (209); or the company relocates the CEO to a different geographic location (186). A number of contracts include a variety of other defined terms as to what constitutes good reason, too. However, a significant percentage of the employment contracts do not mention terminations for good reason (82), while a smaller group mentions termination for good reason but leave the term undefined (18).

Table 8: Actions Defined as Grounds for CEO Quitting With Good Reason

Action	# of Contracts	% of All Contracts
Not mentioned	82	21.87%
Mentioned but not specified	18	4.80%
Duties inconsistent with CEO position	253	67.47%
Relocation	186	49.60%
Failure to compensate	209	55.73%
Other	216	57.60%

Only 266 contracts require the CEO to give notice a specific period before quitting either with or without good reason. If the CEO quits for a good reason, the mean notice period is 28.50 days, although the contracts range from zero to

180 days. The notice period is sometimes longer if the CEO quits voluntarily (i.e., without good reason). In this situation, the average notice period is 45.32 days, varying from zero to 360 days. However, the median notice period is thirty days for both situations.

Based on our examination of the contracts, we find that CEOs terminated for good reason generally get the same severance payments as when they are fired without cause. Similarly, although we have not expressly quantified the effect on CEO severance pay of quitting for good reason versus quitting without good reason, our review of the contracts shows that it is similar to the differences for termination without cause versus termination with cause.[36]

B. Noncompetition Clauses

One of the major issues in a CEO contract is whether the CEO can continue working in the industry after leaving the particular company. From the company's perspective, it does not want a CEO to learn its strengths and weaknesses and then go to work for a competitor and exploit that inside knowledge. From the CEO's perspective, the CEO does not want to be trapped in a particular company if another firm can better use (and compensate) his or her expertise in the industry.

In our sample of CEO contracts, about one-third (122 out of 375) do not have explicit Do-Not-Compete (DNC) clauses. As Table 9 shows, for the remaining 253 contracts (about two-thirds of the total), the most common time restriction is two years (118). Other common lengths for Do-Not-Compete clauses are one year (80) and three years (29). Only ten contracts restrict the

36. We also note that an important number of contracts have indemnification clauses that provide CEOs with contractual rights to have the company pay their expenses in the event that they are sued in connection with their current or past relationship with the company. For example, clause eleven of Clear Channel Communications' CEO's contract provides:

> Executive shall be indemnified and held harmless by the Company to the fullest extent authorized by Texas law, as the same exists or may hereafter be amended, against all Expenses incurred or suffered by Executive in connection therewith, and such indemnification shall continue as to Executive even if Executive has ceased to be an officer, director, trustee or agent, or is no longer employed by the Company and shall inure to the benefit of his heirs, executors and administrators.

Contracts may also require the company to purchase liability insurance to provide some coverage for the CEO in case of a lawsuit. For example clause nine of Hewlett-Packard's CEO's contract provides: "The Company shall cover Executive under directors and officers' liability insurance both during and, while potential liability exists, after the Employment Term in the same amount and to the same extent, if any, as the Company covers its other officers and directors."

CEO from competing for four to five years, and no contract has a longer restriction.

Table 9: Lengths of Non-Competition Period

DNC Length (Years)	# of Contracts	% of All Contracts
N/A, No DNC clause	122	32.53%
Length not specified	1	0.27%
0.25	1	0.27%
0.50	4	1.07%
1.00	80	21.33%
1.50	9	2.40%
2.00	118	31.47%
2.50	1	0.27%
3.00	29	7.73%
4.00 ≤ Length ≤ 5.00	10	2.67%
Total:	375	100.00%

As Table 10 shows, 180 of the 253 contracts that have Do-Not-Compete clauses are triggered by any termination, regardless of whether the CEO quits or the company fires the CEO, with or without cause. Rank-and-file employees often complain, sometimes successfully, when they are forbidden from competing after being fired by the company, arguing they did not choose to leave the company.[37] A few CEO contracts address this concern. Twenty-one contracts trigger the non-competition clause when the CEO is fired for cause, rather than fired for any reason. On the other side, twenty-four contracts trigger non-competition clauses when the CEO quits without good reason, while only three are triggered if the CEO quits with good reason and four are triggered any time that the CEO quits. But these more nuanced clauses are a distinct minority of the non-competition clauses we surveyed.

37. *Compare* Robert S. Weiss & Assoc. v. Wiederlight, 546 A.2d 216, 221 (Conn. 1988) ("[T]he reasonableness of a restrictive covenant of employment does not turn on whether the employee . . . left his position voluntarily or was dismissed by the employer.") *with* Ma & Pa, Inc. v. Kelly, 342 N.W.2d 500, 502 (Iowa 1984) (noting that dismissal is factor opposing injunction), *and* Insulation Corp. of Am. v. Brobston, 667 A.2d 729, 738 (Pa. Super. Ct. 1995) (refusing to enforce non-competition clause because employee fired for poor performance cannot pose the same competitive threat as one who voluntarily joins another business).

Table 10: Triggers for Do-Not-Compete Clause

Terminations Triggering DNC	# of Contracts	% of All Contracts
N/A, No DNC clause	122	32.53%
Trigger not specified	0	0.00%
Any termination	180	48.00%
Any termination by firm	13	3.47%
Termination by firm without cause	5	1.33%
Termination by firm with cause only	21	5.60%
Any termination by CEO	4	1.07%
Voluntary termination by CEO without good reason	24	6.40%
Termination by CEO with good reason	3	0.80%
During severance period	26	6.93%

We next test the hypothesis that in contracts including a non-competition clause, contract length should be correlated with the length of the severance payments set by the terms of the contract. The premise here is that the two should be correlated because this ensures that the departing executive is compensated for his or her period of forced unemployment. Using the contracts with a specified non-competition period that also have specified severance payments, we find little evidence to support this hypothesis. The correlation between these two variables is low, just 0.11, and statistically non-significant (N=177, p-value=0.146). However, Table 11 shows that of the 177 cases that exhibit both non-compete clauses and severance payments, 149 (84.18%) have a severance payment that is equal or greater than the length of the non-competition period. This suggests that the executive is, on average, more than adequately compensated for his or her forgone salary during this period of forced non-competition.

Table 11: CEO Contracts by Length of Non-Competition Period and Severance Payment

Severance Payment (% of Base Salary)	Length of Non-Competition Period (Years)								
	0.5	1	1.5	2	2.5	3	4	5	Total
0%	0	1	0	3	0	0	0	0	4
50%	0	0	1	2	0	0	0	0	3
60%	0	1	0	0	0	0	0	0	1
100%	1	10	1	5	0	2	0	2	21
150%	0	0	2	1	0	0	0	0	3
195%	0	1	0	0	0	0	0	0	1
200%	1	26	2	41	0	3	1	2	76
250%	0	2	0	3	1	1	0	0	7
260%	0	0	0	1	0	0	0	0	1
299%	0	0	1	1	0	0	0	0	2
300%	1	14	0	24	0	9	0	2	50
400%	0	0	0	1	0	0	0	0	1
500%	0	1	1	1	0	1	0	1	5
600%	0	1	0	0	0	0	0	0	1
700%	0	0	0	1	0	0	0	0	1
Total	3	57	8	84	1	16	1	7	177

C. Arbitration Clauses

Moving away from compensation issues, we find that 156 of the 375 (41.6%) CEO contracts include a clause agreeing to arbitrate rather than litigate disputes. A hotly debated topic in employment law is whether the law should allow employers to insist that their employment disputes be submitted to binding arbitration rather than to a court. Many scholars fear that such mandatory arbitration clauses are the result of coercive employers forcing them on workers with little bargaining power. Our findings cast doubt on that assertion. Even CEOs, who are generally employees with considerable bargaining power, seem willing to bind themselves to arbitrate contractual disputes.

Arbitration clauses divide generally into two types: clauses that require arbitration of all disputes between the parties and clauses that require arbitration for all disputes except those related to noncompetition, nonsolicitation, confidentiality, and intellectual property. In this second class of clauses, the company considers that non-compliance by the executive with these particular provisions would result in irreparable harm to the company's interests. Frequently the company expressly reserves the right to seek injunctive relief in a court or appropriate forum. In addition, many of these clauses address the procedures to follow in the event of the need for arbitration: how, when, and where to file the demand for arbitration; who will select the arbitrators; and who pays the costs associated with it.

V. Corporate Law Issues

A. Competing Theories About CEO Contracting

Executive compensation is one of the hottest corporate governance issues today.[38] As public outrage over large pay packages grows and pressure to come up with new checks on CEOs' pay becomes a frequent topic in editorial columns, we read regular reports about the huge dollar amounts of the pay packages and number of stock options awarded to corporate CEOs.[39] Some legal scholars have claimed that pay levels are artificially inflated because corporate pay negotiations are not at arm's length but, rather, strongly biased in executives' favor because executives have directors in their back pocket.[40] On the other side, other academics have defended existing compensation practices, claiming that they reflect efficient contracting and arguing that only a few bad apples need to be punished.[41]

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38. *See* Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What the Problems Are, and How To Fix Them*, Harvard Business School NOM Research Paper No. 04-28 (July 12, 2004), *available at* http://ssrn.com/abstract=561305 (surveying why these issues have become so important and how to analyze them).

39. For example, the *Wall Street Journal*, the *New York Times*, and several other news services publish annual executive pay surveys that highlight pay increases and levels.

40. *See* BEBCHUK & FRIED, *supra* note 2, at 27 (arguing that because directors generally have insufficient incentives to remain independent, they often are controlled by corporate executives).

41. *See, e.g.*, Kevin J. Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS 2485, 2486–88 (Orley Ashenfelter & David Card eds., 1999) (surveying the

In a perfect world, we would be able to resolve this debate by observing the actual negotiations that take place between incoming CEOs and boards of directors to determine the relative negotiating strength of the two sides. Instead, as we earlier noted, all we can examine is the outcome of their negotiations as manifested by the size of the compensation package or terms of their employment contract. In this section of the Article, we report more information about the employment contracts, and we also try to infer some further information about the negotiations that took place by looking at the employment contracts' terms and comparing them to the terms of change-in-control agreements.

B. Change-in-Control Agreements

Change-in-control agreements are negotiated to insure that the CEO will have the appropriate incentives to do what is best for the company's shareholders if the company becomes a takeover target. The change-in-control agreement does this by insuring that, if a CEO is terminated after a takeover, he or she receives payments equal to his or her forgone future compensation. In theory, this should enable the CEO to determine whether to resist the takeover based solely on his or her belief about what is best for the company's shareholders. Importantly, however, an acquirer, at least initially, bears the cost of change-in-control agreements, which may reduce the incentives of board members to negotiate hard to keep these payments as low as possible.

To operationalize the protections of a double trigger change-in-control agreement, the agreement must define the events that permit an executive to terminate his or her own employment for good reason and thereby trigger the severance payments provided for in the change-in-control agreement.[42] Several competing forces operate in the good reason, or constructive termination, provisions in a change-in-control agreement. One important factor is that these provisions may be much more easily triggered by a departing executive because, in some sense, they represent the constructive termination arrangement that the executive would like to have had in the first place but could not get from any employer. From the employer's perspective, it can afford to draft these provisions leniently because in the employer's view, they involve a future buyer's money. In other words, these provisions will only become operative if

literature).

42. In single trigger change-of-control agreements, the executive can obtain these severance benefits after a defined change of control even without a good reason termination.

the company is sold to another company, and that buyer will be responsible for paying the departing executive.

On the other hand, the current employer may care very much about these provisions if it believes that being able to insure that the executive stays with the new buyer will be an important "asset" in a sale. In this scenario, the executive is a key asset of the business when it is sold, and so the board will not want the executive to be able to walk out the door right after the sale. This suggests that a company may want tight constructive termination provisions in its CEO's change-in-control arrangement. Companies which have a significant equity owner, such as a private equity fund portfolio company, would tend to avoid hair-trigger constructive termination arrangements because those owners know that without the executives in place, they are not going to get top dollar for the business.

To compare our change of control agreements with our employment contracts, we first eliminated from the sample all of those employment contracts which also contained change of control provisions. We then analyzed the resulting subset of contracts, which we call "pure" contracts to determine how they defined "good reason." These results are presented in Table 12A below.

Table 12A: Actions Constituting Good Reason in "Pure" Regular Contracts

Action	# of Contracts	% of All Contracts
Not mentioned in contract	38	35.85%
Mentioned but not specified	7	6.60%
Duties inconsistent w/CEO pos	51	48.11%
Relocation	33	31.13%
Failure to compensate	42	39.62%
Other	47	44.34%
Total:	106	100.00%

Table 12B below presents data on the 121 change-in-control agreements in our sample.[43] When we compare the values shown here with those contained

43. We should also note that 269 of our 375 employment contracts give CEOs greater dismissal protections in the event of a change of control transaction. We have not separately analyzed these provisions, although that may be a fruitful area for future research.

in Table 12A above, we see that the change-in-control agreements are more likely to include strong definitions of good reason terminations than regular employment contracts. For example, only twenty out of 121 (16.53%) change-in-control agreements fail to define or mention good reason terminations.[44] In contrast, forty-five out of 106 (42.45%) employment contracts do not contain such language. For the 101 change-in-control agreements in our sample that do define good reason, we find that a CEO can trigger a good reason termination if he or she is assigned duties inconsistent with his or her prior position (99 out of 101); he or she is geographically relocated (89 out of 101); the company fails to compensate him or her (97 out of 101); and a host of other reasons (78 out of 101). These proportions, except for the "mentioned but not specified" category and the "other" category, were found to be statistically significantly higher than for our sample of pure employment contracts.[45]

Table 12B: Actions Constituting Good Reason in Change-in-Control Agreements

Action	# of Agreements	% of All Agreements
Not mentioned	15	12.40%
Mentioned but not specified	5	4.13%
Duties inconsistent with CEO position	99	81.82%
Relocation	89	73.55%
Failure to compensate	97	80.17%
Other	78	64.46%

Another important issue concerning change-in-control agreements is whether the departing executive is viewed as potentially dangerous if he or she is able to compete (for example, because he or she knows secret processes or customers). In this situation, current employers might trade strong constructive termination arrangements for tighter and longer non-competition agreements. This suggests that we should see strong do-not-compete provisions in change-in-control agreements.

44. The bulk of these twenty agreements have provisions that are more favorable for CEOs, including several that pay out benefits whenever a change of control occurs even if the executive is not terminated, and others that pay benefits to the executive after a change of control unless they are terminated for cause by the acquirer. This strengthens our main point here—that CEOs get more protection in change-in-control agreements than in their employment contracts.

45. Tests for differences in proportions were performed at a 1% significance level.

Again, we present the data for the 106 pure employment contracts in our sample. They show that the majority of such contracts contain do-not-compete provisions, with one and two years being the most frequent length.

Table 13A: Lengths of Non-Competition Period for "Pure" Regular Contracts

DNC Length (Years)	# of Contracts	% of All Contracts
N/A, No DNC clause	36	33.96%
0.50	1	0.94%
1.00	23	21.70%
1.50	2	1.89%
2.00	34	32.08%
3.00	6	5.66%
4.20	1	0.94%
5.00	3	2.83%
Total:	106	100.00%

By contrast, the data in Table 13B show that the vast majority of change-in-control agreements do not have such provisions: in ninety-one of our 121 change-in-control agreements, there is no do-not-compete clause. This is particularly striking because only twenty-six of these 121 change-in-control agreements are for executives that have employment agreements.[46] Furthermore, even with those change-in-control agreements that do have do-not-compete clauses, they appear to be shorter than those found in employment contracts. Thus, the most common length of a do-not-compete clause in a change-in-control agreement is one year, whereas with an employment agreement the most common provision lasts for two years. We find that 66.04% of pure CEO employment contracts have do-not-compete clauses, whereas only 24.79% of change-in-control agreements contain such clauses. The difference between these two proportions is statistically significant at less than the 5% level of significance. Again, we view this as evidence that CEOs do not get everything they want in their employment contracts, and that boards

46. For the twenty-six CEOs with both agreements, only five of the employment contracts have do-not-compete clauses: one that lasts one year, one that lasts two years, and three that last three years.

succeed in protecting the corporation's interests, at least to some extent, in those negotiations.

Table 13B: Lengths of Non-Competition Period for Change-in-Control Agreements

DNC Length (Years)	# of Agreements	% of All Agreements
N/A, No DNC clause	91	75.21%
0.25	1	0.83%
0.50	2	1.65%
1.00	10	8.26%
1.50	4	3.31%
2.00	6	4.96%
2.50	1	0.83%
3.00	5	4.13%
5.00	1	0.83%
Total:	121	100.00%

An important zero-sum negotiation between employer and executive regarding change-in-control arrangements is whether the executive gets grossed-up for golden parachute excise taxes. A gross-up (the iterative asymptotic calculation that keeps on taking into effect the incremental tax on the incremental payment being made to an executive to compensate him for that very tax) greatly increases the cost of the change-in-control payment to the employer at the same time that it deprives the employer of the tax deduction on those payments. We find that fifty-four of our 121 change-in-control agreements provide for tax gross-ups for CEOs. As there is no analogous type of surcharge on the basic forms of compensation provided for in CEO employment contracts, we cannot draw any inferences about the parties' bargaining strength from this fact.

C. *Restrictions on Hedging or Pledging Stock Options*

The literature on executive compensation debates whether corporate executives can engage in hedging or pledging transactions for the stock options that they hold.[47] The issue is important because the fundamental rationale for

47. *See, e.g.*, David M. Schizer, *Executives and Hedging: The Fragile Legal Foundations of Incentive Compatibility*, 100 COLUM. L. REV. 440, 465 (2000) ("Whereas existing contractual

awarding managers large blocks of stock options is to align their interests with those of corporate shareholders.[48] Executives that hold large blocks of options have incentives to get the company's stock price up so as to maximize the value of their options. This encourages them to work harder and focus more clearly on maximizing shareholder value. If these managers can use the derivatives market "to trade stock options for fixed payment streams based on factors other than the company's performance,"[49] then the goals of performance-based compensation will be seriously undermined.

Dean Schizer has claimed that executives are severely constrained in their ability to engage in hedging or pledging of their stock options.[50] He looks at two types of potential contractual limitations on derivative transactions in stock options: stock option restrictions and insider trading policies. He claims that a typical stock option plan bars pledging of stock options, but not hedging of them.[51] Firms that have insider trading policies, on the other hand, usually do constrain hedging transactions, according to Schizer, although not all firms have such policies.[52] He does not, however, discuss whether firms ever include such constraints in their managers' employment contracts.

Our data set provides us with the ability to examine whether contracts constrain executives from engaging in hedging or pledging of their stock options in their employment agreements. We find that 271 of the 375 employment contracts (72.27%) in our sample discussed the executive's stock option compensation; they usually included references to the various incentive compensation plans offered by the company to its executives. Of these 271 contracts, five restricted the executive's sale of stock options. None of them restricted hedging of options. Only three contracts restricted or prohibited the executive's ability to pledge options. However,

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and securities law constraints are sufficient to block many instances of options hedging, they do not provide a complete barrier."); Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 301 (1995) ("Executive compensation has been the subject of a raging controversy in recent years."); Robert Dean Ellis, *Equity Derivatives, Executive Compensation, and Agency Costs*, 35 HOUS. L. REV. 399, 427 (1998) ("[T]he regulatory framework tends to address technical features of such instruments [as stock options] rather than their potential misuse.").

48. Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 37–38 (2000) (summarizing rationale for the use of stock option plans).

49. *Id.* at 45.

50. Schizer, *supra* note 47, at 445–46. *But see* Bank, *supra* note 47, at 332 (concluding that these constraints are not as severe as often claimed); Ellis, *supra* note 47, at 441 (same).

51. Schizer, *supra* note 47, at 460. This is consistent with our observations of various stock option plans that are attached to some of our employment contracts.

52. *See* Schizer, *supra* note 47, at 460 (citing to his discussions with three particular law firm partners and some investment bankers in support of this claim).

one of these contracts is unusual in that the shares issued to the executive were unregistered stock, and therefore subject to federal securities law's restrictions on its resale under the 1933 Securities Act. These figures support the claim that companies do little in executive employment contracts to restrict their executives' ability to engage in derivative transactions with their stock options.

D. Perquisites

CEO perks are a hot topic in the popular press.[53] In Table 14 we present some summary statistics for some of the more common perquisites given to CEOs in their employment contracts. We focus here on six of the more salient forms of perquisites: automobiles[54] (144 out of 375 contracts), country club memberships[55] (92 out of 375 contracts), personal use of the company's aircraft (27 out of 375 contracts), company-paid travel for the CEO's spouse (20 out of 375 contracts), loans to the CEO (26 out of 375 contracts), and company-paid apartments for the CEO's personal use (8 out of 375 contracts). In addition, a large proportion of the contracts in our sample included at least one of the following benefits: supplemental retirement plans (SERPs), executive pensions, or financial counseling benefits (217 contracts).

Table 14: Perquisites Mentioned in CEO Contract

Type of Perquisite	# of Contracts	% of All Contracts
Apartment	8	2.13%
Company aircraft	27	7.20%
Company car or car allowance	144	38.40%
Country/social club	92	24.53%
Loan of any kind	26	6.93%
Spouse travel	20	5.33%
SERP, Pension, or Financial advice	217	57.87%

53. *See, e.g.*, *Perks as Varied as Recipients; Firms Pick Up Tabs for Country Club, Even Pay CEOs' Taxes*, HOUS. CHRON., May 12, 2003, at B3; *Tyson Serves CEO Bigger Portions of Pay, Perks*, CHI. TRIB., Jan. 3, 2003, at N2; Michael Skapinker, *Perks That Go Too Far: CEOs Are Paid More Than Enough—They Should Be Able to Buy Their Umbrella Stands*, FIN. TIMES, Sept. 25, 2002, at 18; James F. Peltz, *For CEOs, It's a Lot Lonelier at the Top; Scandals: The Pay and Perks Still are Lavish, but Many Executives Bristle at the Public's Scorn*, L.A. TIMES, Jul. 18, 2002, at 1; Carrie Johnson, *As Perks Go, This One's a Gas; Workers Benefit From CEO's Love Affair With Corvettes*, WASH. POST., Jun. 1, 2001, at E1.

54. Ten of these contracts also included a personal driver for the CEO.

55. An additional seven contracts provided fitness club memberships for the CEO.

Theorists have interpreted perquisite consumption in different ways. Professor Fama has argued that executives trade off perquisites for other forms of compensation, so that CEOs receiving valuable benefits also take home smaller paychecks.[56] Under this theory, consumption of perquisites is an agency cost only if not offset by reduced pay levels. Jensen and Meckling take a more negative view and argue that perquisite consumption constitutes a diversion of firm resources that results in a straight out reduction in firm value.[57] If we accept their view of perquisites, then the data in Table 14 could represent pure agency costs. One recent paper has empirically tested these theories using data on the personal use of corporate aircraft by CEOs, and found some evidence supporting both views.[58]

VI. Conclusion

In this paper, we examine the employment contracts and change-in-control agreements for a large sample of CEOs of S&P 1500 companies. We find evidence that CEOs have significant bargaining power in their negotiations over the terms of their employment contracts and change-in-control agreements. Furthermore, the differences between these CEO contracts and those of other corporate workers seem quite stark. While more work needs to be done in order to conclusively determine whether the negotiations between CEOs and their boards are arm's length, or one sided, and what are all the differences between CEO and rank-and-file employment arrangements, our data offer some valuable insights into these questions and help to inform these ongoing debates.

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56. Eugene F. Fama, *Agency Problems and The Theory of The Firm*, 88 J. POL. ECON. 288 (1980).

57. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 325–28 (1976).

58. David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, Unpublished Working Paper, September 2004 (on file with the Washington and Lee Law Review).

VII. *Basic Data Appendix*

Firm Characteristics

Variable	# of Contracts	Mean	Std Dev	Minimum	Maximum
Market Capitalization (billion $)	373	5.575	15.532	0.021	164.773
Number of Employees	371	18,340	36,452	20	316,303

SIC Division	# of Contracts	% of All Contracts
Mining	12	3%
Construction	6	2%
Manufacturing	139	37%
Transportation, Communications, Electricity and Gas	49	13%
Trade	46	12%
Finance, Insurance	46	12%
Services	77	21%

Compensation Characteristics

Variable	# of Contracts	Mean	Std Dev	Minimum	Maximum
Salary (as time contract signed)	370	643,212	309,829	90,000	2,500,000
Total Compensation (million $)	359	1.649	1.510	0.125	11.244

Variable	# of Contracts	% of All Contracts
Bonus Mentioned in Contract	338	90%
Long-Term Incentive Plan Mentioned in Contract	258	69%

Basic Contract Characteristics

Variable	# of Contracts	% of All Contracts
Arbitration Clause to Solve Disputes	156	42%
Definite Term Contracts	326	87%

Variable	# of Contracts	Mean	Std Dev	Minimum	Maximum
Length of Contract if Definite (Years)	326	3.64	1.52	1.00	10.00

Non-Competition Clauses

Variable	# of Contracts	% of All Contracts
Do-Not-Compete Clause in Contract	253	67%

Variable	# of Contracts	Mean	Std Dev	Minimum	Maximum
Length of Non-Competition Period (Years)	252	1.86	0.89	0.25	5.00

Termination Provisions By Company

Variable	# of Contracts	% of All Contracts
Change in Control Gives CEO Greater Rights/Compensation	269	72%
CEO Can Be Dismissed For Just Cause	362	97%

Notice Firm Must Give Before Terminating CEO for Just Cause	# of Contracts	% of All Contracts
Not mentioned	87	23%
Mentioned but days not specified	85	23%
Days in advance specified	203	54%

Variable	# of Contracts	Median	Mean	Std Dev	Min	Max
Days of Notice Firm Must Give Before Terminating CEO for Just Cause (if specified)	203	0	11.95	17.02	0	60

Notice Firm Must Give Before Terminating CEO Without Just Cause	# of Contracts	% of All Contracts
Not mentioned	159	42%
Mentioned but days not specified	46	12%
Days in advance specified	170	45%

Variable	# of Contracts	Median	Mean	Std Dev	Min	Max
Days of Notice Firm Must Give Before Terminating CEO Without Just Cause (if specified)	170	30	28.77	40.96	0	360

Termination Provisions by CEO

Variable	# of Contracts	% of All Contracts
Explicit Clause Says CEO Can Quit With Good Reason	293	78%

Stock Option Clauses

Variable	# of Contracts	% of All Contracts
CEO Gets Restricted Stock	114	30%
Stock Options Mentioned in Contract	271	72%

CEO Characteristics

Variable	# of Contracts	Mean	Std Dev	Minimum	Maximum
CEO Age	369	54.50	6.90	36	77